



Australian Financial Services Licence 259094
Street Address: Level 3, Benson House, 2 Benson Street, Toowong Qld
Postal Address: P.O. Box 4019, St Lucia South, Queensland 4067

Tel/Fax: (07) 3870 3550
E-mail: info@leithner.com.au
Website: www.leithner.com.au

Investment Philosophy

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Confronted with a challenge to distil the secret of sound investment into three words, we venture the motto, Margin of Safety.

Benjamin Graham
The Intelligent Investor (1949)

To invest successfully, you need not understand beta, efficient markets, modern portfolio theory, option pricing or emerging markets. You may, in fact, be better off knowing nothing of these. That, of course, is not the prevailing view at most business schools, whose finance curriculum tends to be dominated by such subjects. In our view, though, investment students need only two well-taught courses – How to Value a Business, and How to Think About Market Prices.

Your goal as an investor should simply be to purchase, at a rational price, a part interest in an easily-understandable business whose earnings are virtually certain to be materially higher five, ten and twenty years from now. Over time, you will find only a few companies that meet these standards – so when you see one that qualifies, you should buy a meaningful amount of stock. You must also resist the temptation to stray from your guidelines: if you aren't willing to own a stock for ten years, don't even think about owning it for ten minutes. Put together a portfolio of companies whose aggregate earnings march upward over the years, and so also will the portfolio's market value.

Warren Buffett
[Letter to Berkshire Hathaway Shareholders](#) (1996)

[Benjamin Graham](#) (1894-1976), author of *Security Analysis* (1934) and *The Intelligent Investor* (1949), was a principal of Graham-Newman Corp. (1926-1955). He is also regarded as a (and perhaps the primary) founder of modern financial analysis. Leithner & Co. is a Graham-style [value investor](#).

Graham's key insight is that "investment is most successful when it is most businesslike. An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return." Operations not meeting these requirements are speculative. Value investors recognise that price is what is paid and that value is what is received; observe that over time price and value gravitate towards one another but that at any given point in time may diverge (sometimes by a wide margin); and lament that most people rarely recognise – and more than a few wilfully ignore – the fundamental distinction between value and price.¹ Graham's followers emphatically reject the prevailing view that the price and value of a security (i.e., stock, bond, title to real estate) necessarily coincide at all times.

In order better to appreciate the distinction between price and value, Graham urged market participants to ignore "the market" and to focus upon the individual business which issues a security such as a stock. The investor regards a stock as a share in the ownership of a business, and its value will over time correspond to that of the entire enterprise. From this insight follow two others:

1. under certain conditions a security can be purchased at a price less than its value, and the greater this disparity the greater the investment's "margin of safety."

¹ Actually, that's not quite true. At the 2002 Annual General Meeting of [Wesco Financial Services](#), which he chairs, [Charles Munger](#) fired a round of glorious fusillades. He believes that there is much that is wrong with universities, and if he could he would remove three-quarters of the faculty – everything but the hard sciences. But he is in no position to do so, and nobody else is going to do it, and so these pernicious defects are likely to persist. "It's amazing how wrongheaded [the teaching is]. There is fatal disconnectedness. You have these squirrely people in each department who don't see the big picture." Broadening his attack, Munger acknowledged that this perversity does not just occur within universities. Companies, too, are balkanised. "Look at what happened at Arthur Andersen and Enron. They weren't all bad people, but their cultures were dysfunctional. It's easy to create such a culture, in which you have good people but terrible results. Many areas of government are dysfunctional. Universities are complicit. They don't feel guilty about the product they're producing ..."

The hordes of cookie-cutter MBAs and investment professionals who have swallowed mainstream dogma make value investors' lives much easier than they should or otherwise would be. In any sort of contest – financial, mental or physical – it is a great advantage to have opponents who have been taught, in effect, that it is useless to think. In a game of bridge, you stand to benefit if the opposing team refuses even to look at its cards. In order to cement this advantage, Mssrs Buffett and Munger have publicly pondered whether they should endow chairs to ensure the perpetual teaching of mainstream finance (see, for example, Robert Hagstrom, *The Warren Buffett Portfolio* (John Wiley & Sons, 1999, p. 34).

2. to obscure the relationship of value to price – for example, to buy a security on the basis of its current popularity and in the hope that its price, reflecting this popularity, will shortly rise – is to forsake investment and embrace speculation. Indeed, from the perspective of a Graham-style value investor the vast majority of transactions occurring every day in financial markets are speculations rather than investments.²

Prominent value investors, such as Graham’s one-time students and employees [Warren Buffett](#), Thomas Knapp and [Walter Schloss](#), regard themselves not as traders of pieces of paper but as part-owners of tangible businesses. As such, they seek to allocate capital on the basis of justifiable premises, valid logic and hard evidence – not popularity or emotion; to reduce the risk of permanent loss of capital (as opposed to temporary “mark-to-market” loss); to be cautious when others are confident, calm when others are fearful and deliberate at all times; and to focus upon the value (as opposed to the market prices) of the securities which they own and seek to own. These insights imply ten principles underpinning Leithner & Co.’s operations.

Principle 1: Ignore “The Market” and “Market Experts”

Graham-style value investors ignore “market experts” and their predictions about the level of or movements in overall financial markets, prices of individual securities, etc.

Market experts, strategists and commentators are, to greater or lesser extents, human beings; *homo sapiens*, since time immemorial, has attempted to prophesy the future; and from the start, the confidence of the general public about the ability of certain people to predict the future has vastly exceeded the actual ability of these certain people to do so. Experts’ inability to prophesy the level of the All Ordinaries and other indices (and the prices of particular securities, etc.) with any reasonable degree of accuracy is a specific instance of people’s basic incapacity to foretell the future.

Graham recognised this human frailty, and noted that highly-trained and otherwise-intelligent specialists in quantitative economics and finance are especially prone to it. “The farther one gets away from Wall Street,” he observed in *The Intelligent Investor*, “the more scepticism one will find about the pretensions of stock-market forecasting or timing.” Indeed, “in our experience and observation, extending over 50 years, we have not known a single person who has consistently or lastingly made money by ‘following the market.’ We do not hesitate to declare that this approach is as fallacious as it is popular.”³

² For details, see Chap. 1 of *The Intelligent Australian Investor: Timeless Principles and Fresh Applications*, John Wiley & Sons, 2005).

Graham also noted that “aside from forecasting the movement of the general market, much effort and ability are directed in Wall Street toward selecting stocks or industrial groups that in matter of price will ‘do better’ than the rest over a fairly short period in the future.” He concluded “we do not believe [this endeavour] is suited to the needs and temperament of the true investor. As in all other activities that emphasise price movements first and underlying values second, the work of many intelligent minds constantly engaged in this field tends to be self-neutralizing and self-defeating over the years.” Further, “if as we suggest the average market level of most ‘growth stocks’ is too high to provide an adequate margin of safety for the buyer, then a simple technique of diversified buying in this field may not work out satisfactorily.”

A comprehensive study published in the *Hulbert Financial Digest* in January 1994 corroborates this position (see also William Sherden, *The Fortune Sellers: The Big Business of Buying and Selling Predictions*, John Wiley & Sons, 1998). Hulbert found that, of the 108 market timing and economic forecasting newsletters analysed during the preceding five years, the predictions of only two corresponded even crudely to subsequent events. This number is much smaller than would be expected by pure chance, and thereby suggests that although experts cannot get things systematically right they can and do get things comprehensively wrong.⁴ Market strategists, commentators and gurus, it seems, are seldom in doubt but virtually always in error. It is noteworthy that Warren Buffett and [Peter Lynch](#), two of the most successful investors of the last four decades, expressly disclaim any ability to predict markets’ level. In Lynch’s words, market timers “can’t predict markets with any useful consistency, any more than gizzard squeezers could tell the Roman Emperors when the Huns would attack.”⁵

What, then, to make of market experts? They encapsulate and disseminate the prevailing conventional wisdom of the moment. They tell us what is presently exciting, depressing or otherwise attracting the herd’s attention. Experts don’t *influence* mass expectations, and still less do they *create* them. Instead, they *reflect* them. Another impression is that strategists’ “model” is, deep down and stripped of all its complexities, nothing more than a one-parameter regression. On average since the mid-1920s, the S&P 500 has increased, on average, by x%

³ In Berkshire Hathaway’s 1980 Annual Report, Buffett added that “forecasts may tell you a great deal about the forecaster; [but] they tell you nothing about the future.”

⁴ A current (as of 13 February 2009), subjective but thorough and thought-provoking compendium of gurus’ ability to forecast appears at [Guru Stock Market Forecasting Grades](#). “In summary,” it says, “stock market experts as a group do not reliably outguess the market. Some experts, though, may be better than others.”

⁵ For a demonstration from first principles of the folly of market timing, see Chap. 2 of *The Intelligent Australian Investor* and a circular to shareholders entitled [Why Speculation Inevitably Ends in Tears](#).

per year. From the early '80s to the late '90s, it rose by $y\%$ per year on average (where $y > x$). So, as a baseline, strategists will tell us that, during the next year, the S&P will rise by $(x+y)/2$ percent.

If you're thinking to yourself, "that's a needlessly convoluted way of saying that market experts simply take the market index's historical average rate of increase as a baseline, add to it if the herd's bullish and subtract from it if the crowd's bearish," then perhaps a career as a market strategist awaits you. Clearly, these means have standard deviations, and so the experts pad their predictions with various fluff ("upside and downside risks," "uncertainty," etc.). During booms, the crowd expects – nay, *demands* – above-average results, and during busts it fears subpar ones. Hence the crowd extrapolates the immediate past into the indefinite future. Consciously or not, strategists strive to give the people what they want (when they're upbeat) or what they fear (when they're despondent), and incorporate these extrapolations into their public utterances.

So how do such superfluous creatures keep their jobs? Indeed, how do they manage to prosper? Why don't more smart-arses remind strategists of their past utterances? Members of the general public don't, for the most part, like to revisit the mistakes they committed by following the experts. In other words, what's past should remain buried. Further, to direct the strategist to his past vomit is, in effect, to question today's conventional wisdom. But there's strength in numbers, if only psychologically, and to question (never mind deny) the crowd is to ostracise oneself from it. A final point is that strategists aren't remotely troubled by their past utterances because they're incapable of feeling sheepish. That attribute tends to limit their supply, and the public's seemingly insatiable demand for people who tell them what they want to hear ensures that their price in the market remains absurdly high.

Principle 2: Don't Try to Predict "The Economy" – and Ignore Those Who Do

Graham-style value investors pay little attention to forecasts about "the economy," the level and direction of interest rates, the Consumer Price Index, the exchange rate of the Australian dollar vis-à-vis other currencies, unemployment, the balance of payments and who-knows-what else.

Economists' ability to predict these things is at best tenuous. Normally, it's practically non-existent. And even if they could forecast accurately, which they can't, mainstream economists' prognostications distract rather than inform. Hence value investors devote little time to the relentless torrent of prophecies. In Buffett's words (cited in *U.S. News & World Report*, 20 June 1994), "if Fed Chairman Alan Greenspan were to whisper to me what his monetary policy was going to be over the next two years, it wouldn't change one thing I do."

William Sherden reviewed research about the accuracy of economic forecasts that has been conducted since the 1970s. He found that

- economists cannot predict turning points in the economy;
- their ability to forecast accurately is, on average, neither better nor worse than flipping a coin or simply guessing;
- increased sophistication (i.e., more powerful computers, more complicated econometric models and greater amounts of data) has not improved the accuracy of forecasts;
- there is no evidence that forecasters' skill has increased since the 1970s – if anything, their “skill,” such as it is, has deteriorated over time;
- “consensus” forecasts (i.e., the combination of individual forecasts into a single, average forecast) are no more accurate than the individual forecasts which comprise them;
- the further into the future that economists attempt to forecast, the less accurate their forecasts become;
- no individual forecasters are consistently more accurate than their peers.

Given these disconcerting (for mainstream economists!) results, value investors keep firmly in mind two seemingly-flippant but nonetheless vital laws of mainstream economics. The first is that, for every economist, there is likely to be an equal and opposite economist. (This one says up, and that one says down; this one says left and that one says right, blah, blah, blah.) The second law is that both mainstream economists are likely to be wrong. In the words of influential investor Philip Fisher (*Common Stocks and Uncommon Profits*, John Wiley & Sons Investment Classics, 1996), “I believe that the economics which deals with forecasting business trends may be considered to be about as far along as was the science of chemistry during the Middle Ages. The amount of mental effort the financial community puts into this constant attempt to guess the economic future makes one wonder what might have been accomplished if only a fraction of such mental effort had been applied to something with a better chance of proving useful.”⁶

Buffett agrees. “We will continue to ignore political and economic forecasts, which are an expensive distraction for many investors and businessmen,” he said in his letter to Berkshire’s shareholders in 1994. He continued:

Thirty years ago, no one could have foreseen the huge expansion of the Vietnam War, wage and price controls, two oil shocks, the resignation of a president, the dissolution of the Soviet Union, a one-day drop in the Dow of 508 points, or treasury bill yields fluctuating between 2.8% and 17.4%.

⁶ A more detailed discussion and analysis of these points appears in Chap. 7 of *The Intelligent Australian Investor*.

But, surprise – none of these blockbuster events made the slightest dent in Ben Graham’s investment principles. Nor did they render unsound the negotiated purchases of fine businesses at sensible prices. Imagine the cost to us, then, if we had let a fear of unknowns cause us to defer or alter the deployment of capital. Indeed, we have usually made our best purchases when apprehensions about some macro event were at a peak. Fear is the foe of the faddist, but the friend of the fundamentalist.

A different set of major shocks is sure to occur in the next 30 years. We will neither try to predict these nor to profit from them. If we can identify businesses similar to those we have purchased in the past, external surprises will have little effect on our long-term results.

The International Monetary Fund provides a recent, revealing (and, if it weren’t so pathetic, very amusing) example of the persistence of the delusional belief that mainstream economists can foresee the future.⁷ On 12 April 2007, in its [World Economic Outlook](#), the IMF stated “rapid growth in the world economy is set to continue for years and will not be upset by financial instability.” Indeed, it reckoned that the outlook for robust growth and low inflation “is better now than at any time since at least the 1960s, and growth prospects are more balanced around the world now than they were then.” At a news conference celebrating the release of the WEO – and, more generally, the IMF and its alleged wisdom – its chief economist added “I think we can sustain growth at around 5% a year for some time to come ... You will have some ups and downs in financial markets, but as long as the macro-economic policies are sound the issues in finance will not be of first order importance.”

That prophesy, to put it mildly, has deviated somewhat from reality. But no matter: if you don’t at first succeed, then forecast again. Little more than a year later (in its [World Economic Outlook](#) released on 8 October 2008), the IMF issued one of its bleakest assessments. The world, it had suddenly realised, was poised for a “major downturn” and that the U.S. and Europe are “either in or on the brink of recession.” Indeed, it judged that the “worst financial trauma since the Great Depression” could exact a heavy economic toll. “The world economy is now entering a major downturn in the face of the most dangerous shock in mature financial markets since the 1930s.”

⁷ Economists of the Austrian School knew from the start that the IMF was a gang of hopeless and destructive jokes. “The destruction of the monetary order,” wrote Ludwig von Mises in the 1952 edition of *The Theory of Money and Credit*, “was the result of deliberate actions on the part of various governments. The government-controlled central banks and, in the United States, the government-controlled Federal Reserve System were the instruments applied in this process of disorganisation and demolition. Yet without exception all drafts for an improvement of currency systems assign to the governments unrestricted supremacy in matters of currency and design fantastic images of super-privileged super-banks. Even the manifest futility of the International Monetary Fund does not deter authors from indulging in dreams about a world bank fertilising mankind with floods of cheap credit.”

Economic conditions were unusually frail, the IMF confessed, but there was little chance of a global depression – “provided [that politicians] quickly adopt policies to address market distress.” Indeed, “if the right policies are in place, then the probability of a ‘Great Depression’ is extremely small.” In a press conference, its chief economist conceded that “leaders in Europe” were encountering “some difficulty” agreeing how to tackle the crisis, but were making progress. If they succeed (and of course governments always succeed, on time and on budget, and their actions never spawn negative and unintended consequences), “the risk of a ‘Great Depression’ is nearly nil.” In neither its news conference nor in its WEO of October 2007 did the IMF utter a syllable about its failure to foresee this global recession. As for an apology or a note of humility, or some recognition that it had failed to do its job and would strive to do better next time – well, you’ve got to be joking.

Forgetting its rosy assessment of 2007, and utterly oblivious to its (and any mainstream economist’s) utter inability to foresee the eruption of crisis in 2008, the confidence with which the IMF continued to predict remained undimmed. “Intensifying solvency concerns about a number of the largest U.S.-based and European financial institutions have pushed the global financial system to the brink of systemic meltdown,” said its managing director on the weekend of 11-12 October. But don’t worry, its chief economist added: “at the worst, governments will need another few weeks to make the right assessment and the stock exchanges could fall by another 20 per cent. Then there will be a turnaround.”

If on your second try you don’t succeed, you guessed it – forecast again! On 12 February 2009, *The Australian* reported: “International Monetary Fund chief Dominique Strauss-Kahn says the world’s most advanced economies – the U.S., Western Europe and Japan – are already in depression, and that the IMF could slash its global growth forecasts further. ‘The worst cannot be ruled out,’ he said yesterday. The IMF managing director’s comments ... represent the most dire estimate so far of the state of the global economy by a major political figure, and were far more pessimistic than forecasts released as recently as 28 January.”

For investors, the truth will set you free: until it struck, the IMF had no idea that an economic tidal wave would engulf the world. Similarly, until it occurred it was utterly oblivious to the economic crisis in Asia in 1997-98. Like any and every other similar organisation (such the [Organisation for Economic Co-operation and Development](#), central banks, the Treasuries of national governments, private sector forecasters, etc., etc.) the IMF poses and postures, and pontificates and pretends. It desperately wants you to believe than it can, but it simply can’t foresee the future. These organisations strive to give the impression that they know what they’re doing, but they manifestly don’t. Humans’ (including value investors’) inability to prognosticate economic events and developments with any useful degree of accuracy means that they should dis-

count or ignore economists or others who claim that they have a crystal ball. Why any sane person listens to anything these talking heads ever say (except to denigrate them and ridicule it) is completely beyond me.

This stance most emphatically does *not*, however, mean that value investors should ignore the future. Quite the contrary: they plan for tomorrow not by making particular predictions about what will happen but by considering general scenarios – and particularly pessimistic ones – of what might conceivably happen. They then adapt their actions and investments in order to reduce the risk of permanent loss of capital in the event that undesirable events and developments actually occur (see also [Leithner & Co.'s conception of risk and framework for risk management](#)). It is significant that, according to Prof Terrance Odean of the University of California-Davis, “psychologists have found that people who are mildly depressed tend to have the most realistic outlook” (quoted in *The Wall Street Journal* 22 September 1998).

Principle 3: Analyse Individual Businesses, and Not “The Market”

Because Graham-style value investors do not spend fruitless hours obsessing about “the market” or worrying about “the economy”, they can devote considerable time to a far more productive purpose: the search for businesses whose securities are available at reasonable or bargain prices.

To followers of Graham, it bears repeating, investing is most successful when it is rational; and it is most rational when it is most businesslike. “An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative.” Accordingly, with respect to any security under consideration they ask, investigate and answer questions such as:

- is the underlying business understandable and sensible?
- does it have a consistently-favourable operating history? Are there any obvious and major factors which might affect adversely its prospects?
- is its management candid with shareholders? Does it recognise and correct its errors openly? Do managers treat shareholders’ capital as if it were their own?
- do managers eat their own cooking? That is to say, have they invested own money in the company? Do they own a significant percentage of it?

In answering these questions, followers of Graham ground their analysis in simple maths, clear logic and hard evidence. As the preface to the first edition of *Security Analysis* put it, “we are concerned chiefly with concepts, methods, standards, principles, and above all with logical reasoning.” The investor-businessman distrusts the advanced mathematics, statistical models and computations which underlie contemporary finance. Graham’s views were

unequivocal: “In 44 years of Wall Street experience and study I have never seen dependable calculations made about common stock values, or related investment policies, that went beyond simple arithmetic or the most elementary algebra. Whenever [calculus] is brought in, or higher algebra, you could take it as a warning signal that the operator is trying to substitute theory for experience, and usually also to give speculation the deceptive guise of investment.”⁸

Value investors place no value upon others’ optimism and wishful thinking (or, for that matter, others’ despondency); and insofar as possible they exclude emotional considerations from their analyses. Accordingly, and as detailed in [The Mass Media and Value Investing](#), they take at face value little of what they read in newspapers and magazines, accept without careful consideration even less of what they hear on radio and television, run as fast as their legs can carry them from “tips” and never visit investment chat sites on the Internet.⁹

Principle 4: Buy Only When the Price Is Right

When research is able to derive a justifiable estimate of a business’s value (it often cannot); when there is hard evidence that it possesses solid long-term investment value (there often isn’t); and when there exists a “margin of safety” (i.e., the business is selling at a price which is significantly less than a conservative estimate of its value), Graham-style value investors ask themselves a hypothetical question. “If financial markets were to close for the next five years, would I still be happy to own this business’s securities?” Only if the answer is “yes” and there exists no other opportunity that is more compelling do they act. When they act, they act decisively.

If this sounds extraordinary, remember that estate agents do not quote to you on a daily basis the market price of your house. Reflect as well that despite the absence of such daily price quotations you probably do not – unless you bought it in 2004-2007 – lose sleep over its worth. A brief example, which presents fundamentals and ignores myriad details and complications, is set out in a circular to shareholders entitled [Telstra: A Contrarian Case for Caution](#) (see also *The Intelligent Australian Investor*, Chaps. 3-6 and 10-11).

⁸ The source of the quote is Benjamin Graham, “The New Speculation in Common Stocks,” *The Analysts Journal* (June 1958). Warren Buffett has uttered similar sentiments. If they are correct, then a firm that combines Nobel Laureates, extremely sophisticated computer algorithms, mountains of data and tens and perhaps hundreds of billions of borrowed dollars speculates on an unprecedented scale. For details, see Roger Lowenstein, *When Genius Failed: The Rise and Fall of Long-Term Capital Management* (Random House, 2000) and James Grant, *Mr Market Miscalculates: The Bubble Years and Beyond* (Axios, 2008).

⁹ Although they’re hardly complete, examples of the analyses, thought experiments, etc., which value investors routinely conduct are included in circulars to shareholders entitled [‘Irrational Exuberance’ in Australia](#) and [Reasoned Scepticism Versus Irrational Exuberance](#).

Principle 5: Ignore Institutional and Bureaucratic Imperatives

Leithner & Co. resists what Mr Buffett has called the “institutional imperative.” This is the lemming-like tendency, which is particularly marked within large organisations, to imitate others’ behaviour – no matter how silly or self-destructive that behaviour might be.

John Maynard Keynes, the influential (and destructive) British economist and keeper of the investments of King’s College, Cambridge, described the institutional imperative when he noted in *The General Theory of Employment, Interest and Money* (1936) that “[most] investors may be quite willing to take the risk of being wrong in the company of others, while being much more reluctant to take the risk of being right alone.” Peer pressure, in other words, prompts us to do things as members of a group that we would never countenance as individuals. “Groupthink,” as Irving Janis called it and demonstrated in *Victims of Groupthink: A Psychological Study of Foreign Policy Decisions and Fiascos* (Houghton-Mifflin, 1972), has a range of undesirable consequences (see also Gary Belsky and Thomas Gilovich, *Why Smart People Make Big Money Mistakes*, Simon & Schuster, 1999, and *The Intelligent Australian Investor*, Chap. 9).

Unlike most market participants, which run in herds and follow the crowd, followers of Graham are staunch individualists. They work individually or with one or a handful of colleagues but virtually never within large organisations; they seek and analyse primary data and sources of information but discount secondary sources (such as media reports, the assertions of mainstream economists, politicians, et al., and gossip and scuttlebutt); and they draw a sharp distinction between the veracity and the popularity of their actions. They endeavour to use justifiable premises, valid logic and reliable evidence to reach sound conclusions. They are not dissuaded from a course of action simply because alleged experts or “the market” disagree. Nor do they undertake an action simply because others are doing so. As Graham put it in *The Intelligent Investor*, “you are neither right nor wrong because the crowd disagrees with you.” Rather, “you are right because your data and reasoning are right.” Indeed, and as he also emphasised, “the right kind of investor [takes] added satisfaction from the thought that his operations are exactly opposite to those of the crowd.”

The Internet Bubble

The rise of the Internet – and the inflation of the Internet Bubble – provides an outstanding example of the institutional imperative and Leithner & Co.’s resistance to it. From the mid-1990s until the crest of the mania, few “Internet companies” had ever generated any profits, and fewer still had done so consistently. Yet hundreds of billions of dollars had been lavished upon these firms in the expectation that in due course – and surely sooner rather than later – their profits would surge. To the extent that commercial calculation rather than

sheer speculative greed underlay these placements, this veritable tsunami of capital was founded upon the conviction that the Internet would generate enormous returns to those who could most quickly and effectively unlock its potential.

During the second half of the 1990s and into the new century, the Internet and associated phenomena posed tremendous challenges to investors. They asked themselves “is it an unprecedented bonanza of opportunity? Or has it been overhyped into a bubble of unprecedented speculative excess? In response to its development, should investors change – and even abandon – their principles?” Most market participants, referring to each other and the supposed authority of experts rather than to logic and evidence, concluded that the mania was a genuine bonanza and bent their principles in order to suit this conclusion. By the early 2000s, many experts openly derided as superfluous and anachronistic any attempt to use venerable principles and historical standards to estimate the values of these companies.¹⁰

¹⁰ They’ve probably long since forgotten it. But I have contemporaneous notes and a clear memory, and have drawn an enduring lesson.

The event occurred in 2001 at the Customs House in Brisbane, and hailed the internet and bioscience revolutions that would shortly sweep the world. One presenter after another (mostly academics) drove the point that companies in these fields were changing things irrevocably, and he who couldn’t see the train coming and board it would flounder in its wake. Presentation after presentation lauded this company and that one, the research that it was conducting and the revenues that it would soon generate. Not a word was uttered about profits – either current or prospective.

After the main event came the drinkies. Among a small group, comprising mostly academics, I expressed scepticism whether these companies, considered as a whole, would ever earn a penny. Indeed, I wondered whether many would manage to survive for more than a couple of years. I spoke of canals and railways in the 19th century, of air transport in the early 20th century and of another frenzy of technology stocks in the 1960s. In reply came a synchronised gale of laughter. OF COURSE these companies would be profitable, and anybody who didn’t agree “simply didn’t understand.”

That evening I recalled similar conviction, borne of the attitude that experts know best and the benighted should just shut up and do as the experts say, that had been expressed to me not two years before. On that occasion, it came from the mouths of computer boffins. Something called Y2K would cause utter mayhem, they insisted. Except, as we soon learnt, it didn’t.

Three times within a decade, people who argue not from first principles but from a bogus sense of authority have informed their presumed inferiors that unprecedented change is coming. First came the Y2K’ers, then the Internet Brigade and now the Global Warmers. Subsequent events have shown that the first two mobs have soft heads and clay feet. My guess is that the global warmers, too, are utterly deluded. The enduring lesson is that, when an academic or other alleged expert mounts his high horse, doubt him unless and until you have irrefutable grounds to believe him. And whether you believe him or doubt him, always take steps to protect your wallet and your liberty against his predations (see also [Crusoe Visits Academic Island](#)).

Alien to this pervasive spirit of “Groupthink” was a circular to shareholders entitled [The Internet and Value Investing](#). Reasoning from first principles, it came to a sharply contrary conclusion, namely that the economic fundamentals of e-business, e-commerce and so on were not nearly as compelling as the experts insisted and the crowd supposed. It concluded that “the keys to successful investing – as Benjamin Graham outlined them during the 1930s and as Warren Buffett, Walter Schloss and others have practised them since the 1950s – remain the estimation (using cautious and conservative assumptions) of individual companies’ value and the purchase of their securities when they are available at a discount to that value. The advent of Internet and other technologies do not affect – and still less do they upset – these principles.”¹¹

The Consequences of 1.75% and 4.25% and the Great Bubble of 2003-2007

The institutional imperative may be an innate and ineradicable foundation of many market participants’ behaviour. For within a couple of years of the collapse of the Internet Bubble, governments began to inflate the Great Bubble of 2003-2007. One of its offshoots, the mining boom in Australia, made True Believers out of people who really should have known better.¹² Even before they commenced huffing and puffing, Leithner & Co. was wary and at times suspicious. Of particular retrospective interest is a newsletter to shareholders dated 26 June 2002 and entitled [The Consequences of 1.75% and 4.25%](#). It made a series of points that subsequent newsletters¹³ would extend and elaborate.

The first point is that the boom, which governments and central banks inflate, causes the bust. Alas, governments move heaven and earth to prevent the bust

¹¹ Although that series is hardly without its errors and retrospectively silly points, subsequent events (set out in [The ‘New Economy’ and ‘Tech’ Stocks: Speculators Still Don’t Get It](#)) have corroborated its conclusions.

¹² On 27 February 2007, the front page of the business section of *The Australian* profiled the chairman of one of Australia’s most prominent brokerage firms. He congratulated himself, his firm, the financial services industry – and above all the allegedly rude health of stock and credit markets. “I should be beyond being surprised,” the chairman enthused, “but I cannot believe how much money people have available for special opportunities. The level of liquidity amongst private clients is so much larger now than it has ever been.”

The article reassured readers that this chairman “has seen his share of stock market booms and busts – including the 1987 Crash – [and] does not see the current share market boom ending in tears.” “While global markets might pull back, they are actually quite cheap.” The chairman concluded that the Australian market’s boom since 2003 “is much more sustainable” than its predecessors; and thanks to China’s meteoric rise, it rests upon stronger fundamentals than the booms of the past. “This one looks to be a lot more sensibly based.”

¹³ See also the [archive](#) of Leithner & Co.’s newsletters to shareholders.

– which is necessary in order to clear the decks for healthy growth. “[Our] plans for 2002 are based on the premise that many of the excesses of the 1990s remain unrecognised and therefore unpurged, and that the bust may be extended and sharp.” Clearly, the bust of the early 2000s wasn’t sharp and considerable dry tinder remained on the forest floor. As a result, the next fire would be much – and needlessly – worse than the previous one.

The second point is that the boom which was created to avert the consequences of the Internet Bubble, and which became the Great Bubble of 2002-2007, would ultimately do great damage. “Renewed misallocation of resources ... may manifest itself in 2002 through a ‘recovery.’ Whatever the euphoria it incites in financial circles, such a recovery neither causes economic growth nor creates wealth. Rather, it misdirects Australia’s small and eroding pool of funding and thereby weakens the potential for longer term and sustainable prosperity. During 2002, then, Leithner & Co. will be in no hurry to sing ‘Happy Days Are Here Again.’”

What fuelled the Great Bubble? As much as anything, and probably more than most things, interest rates that central and commercial banks connived to suppress below their free market level. “Underlying and encompassing the myriad events of the 2001-2002 financial year is a single, overarching, venerable and seemingly forgotten principle. As detailed in [The Robinson Crusoe Ethic Versus the Distemper of Our Times](#), interest rates, when not manipulated by a central bank, are determined by individuals’ time horizons (or “time preference”) and the rate of return on investment tends to equal the rate of time preference. In the absence of interference, interest rates efficiently co-ordinate the actions of – and convey accurate signals to – borrowers and lenders. Under these conditions, to use the apt phrase of Roger Garrison (*Time and Money: The Macroeconomics of Capital Structure*, Routledge, 2000), interest rates “tell the truth about time.”¹⁴

The fourth point is therefore that, as the Great Bubble inflated, interest rates emitted ever more false and misleading signals to buyers and sellers in markets. “The greater the departure of subsidised from natural rates of interest, the

¹⁴ Conversely, and as detailed in two circulars ([Interest Rates, Corporate Debt and the Business Cycle](#) and [Inflation and Deflation: Some Dissenting Thoughts for Value Investors](#)), interest rates fixed by central banks not only tend to deviate from the truth about time and money (i.e., the natural rate of interest): in retrospect it is clear that at critical junctures subsidised bank rates have unintentionally but nonetheless repeatedly imparted damaging falsehoods about these phenomena. As James Grant has noted (*The Trouble With Prosperity: The Loss of Fear, the Rise of Speculation and the Risk to American Savings*, Random House, 1996), the sin of central bankers is not just that they create credit backed by thin air rather than hard savings. More fundamental is their pretence to knowledge. They pretend to know what no single person or small group of people, no matter how diligent and intelligent, can possibly know: the appropriate rate of interest at which credit (in the form of bank reserves) should be lent and borrowed.

more egregious the misinformation transmitted to borrowers and lenders. From this perspective, the lowest and most artificial rates of interest in a generation are no cause for celebration. Quite the contrary: it is likely that they have induced further “malinvestments” in addition to those undertaken during the mania of the late 1990s.”

“If so, then in the 2002-2003 financial year the unpalatable consequences of 1.75% (in America) and 4.25% (in Australia) may begin to dawn upon yet another class of speculators-who-thought-they-were-investors. Under these circumstances the anguish of debtors, hand wringing of politicians and babble of analysts will fill the air; and vast volumes of verbal fog will distract attention from the causes of the distemper. It is therefore important to bear in mind that increases of artificially-low, bank-imposed interest rates do not *cause* problems; rather, they reveal them. Increases of artificially-low rates, in other words, are the *consequences* of patterns of error set in train by central banks and committed by speculators-who-thought-they-were-investors.”

It’s important to emphasise that a bust denied is a genuine recovery delayed. That is, the frenzied efforts to postpone, mitigate or even prevent the bust caused by the Internet Bubble set the stage for an even more severe reckoning at some point in the not-too-distant future. “Market prices can for a time be suppressed, rational calculation temporarily impeded and hence bubbles can be inflated. But as time passes the cumulatively pernicious consequences of erroneous and irrational calculations become ever more apparent.”

Already in the 2001-2002 financial year it was clear to Leithner & Co. that the U.S. and Australian governments had become the most profligate in each country’s history.¹⁵ Well before 11 September 2001, the U.S. Government commenced its most frenzied spending spree since the 1960s. According to *The Wall Street Journal* (16 May 2002), “although many economists portray this surge in expenditure as a stimulus to growth, the opposite is true. The runaway federal budget, which is up nearly \$300 billion in just the last two years, and the parallel hike in taxes and debt needed to finance this spending binge, is America’s single most ominous domestic economic danger sign.”

Similarly, Australia’s Liberal-National coalition boasted its conservative pedigree but merrily tossed money out the window as if there were no tomorrow. “The key phrases,” *The Australian Financial Review* editorialised on 13 May 2002, “are big spending, big taxing. That is the Howard-Costello government in a nutshell. The size of government in Australia has surged under the six-year stewardship of the Howard Government to the point where overall government spending and taxing have reached record levels as a share of GDP ... But

¹⁵ By late 2006, it had become apparent to Leithner & Co. that the U.S. Government was insolvent. For details, see [Avoid the Rush](#).

it is not just the size of government that is a concern. It is also troubling that the mix of the massive spending spree is generally poorly directed.” According to a former senior Treasury official quoted in the *AFR* on 12 December 2001, the Commonwealth “preaches prudence even though it has balanced its own accounts by raiding ours ... In a recession the automatic stabilisers will push the Budget further into deficit. Any more discretionary spending and we will start to rebuild the public debt mountain we have so painfully paid off.”

The truth, of course, is that governments can grow only by co-opting or commandeering resources owned by individuals or businesses; and individuals and businesses grow richer not by spending but by accumulating and augmenting the productivity of capital goods. Governments never create anything. At best they divert and distort, and at worst they destroy. As [The Consequences of 1.75% and 4.25%](#) ruefully observed, “in Canberra, the Treasurer and a phalanx of analysts and commentators are pointing towards ‘business investment’ as a bulwark of prosperity in coming months and years. According to *The Australian* (16 May 2002), Mr Costello ‘is pinning his hopes for continued strong economic growth on business investment and has singled out nine diverse projects as examples of the bullish investment climate.’”

Lost in the excitement about these projects was the fundamental distinction between investment and consumption (see [Part V of The Robinson Crusoe Ethic Versus the Distemper of Our Times](#)). And obscured within thickets of upbeat rhetoric was the dependence of the government’s “investment,” which actually consumes rather than invests capital, upon government subsidies. What the state says is investment is actually disguised and misdirected government expenditure. The \$1.3 billion Adelaide to Darwin rail project, for example, a boondoggle that no previous Commonwealth government – not even Gough Whitlam’s! – had been willing to underwrite, received \$200 million of direct support from Canberra and more from South Australia; Rio Tinto’s \$1.5 billion aluminium refinery in central Queensland received a \$137 million interest-free loan from the Commonwealth and \$150 million from the Queensland Government; Australian Magnesium Corp.’s \$1.3 billion plant, also in central Queensland, secured at least \$250 million of government loan guarantees; the Commonwealth extended \$356 million of support to the \$1.5 billion Western Sydney Orbital Road, and on and on.

Before, during and after the Internet Bubble the mainstream’s fallacies bred malinvestments.¹⁶ What politicians lauded as “investments,” in other words,

¹⁶ From 2003 to 2005, the capitalisation of Australian Magnesium Corp., plunged by 95% and the company (now called Advanced Magnesium Ltd) nearly collapsed into administration. The construction of the Adelaide to Darwin railway commenced in July 2001 and concluded in September 2003. The first train reached Darwin in January 2004. Alas, these trains failed to generate a profit. Hence Freightlink, the owner of the railway, resolved in

consumed rather than created capital. Going forward, why should Kevin Rudd's boondoggles meet a fate different from John Howard's? Why should Glenn Stevens' campaign to make interest rates lie about time cause less damage than Ian Macfarlane's? It is worth emphasising, whilst reflecting upon the sorry state of contemporary public policy and the fallacious thinking that underlies it, not only that little of value has been learnt in recent decades: even worse, much of great value bequeathed to us by our forebears has been unlearnt and consigned to the dustbin. According to John Stuart Mill's [Essays On Some Unsettled Questions of Political Economy](#) (1844), for example,

The utility of a large government expenditure for the purpose of encouraging industry is no longer maintained. Taxes are not now esteemed to be like the dews of heaven, which return in prolific showers. It is no longer supposed that you benefit the producer by taking his money, provided that you give it to him again in exchange for his goods. There is nothing [to commend the doctrine] that the more you take from the pockets of the people to spend on your own pleasures, the richer they grow; that the man who steals money out of a shop, provided that he expends it all again at the same shop, is a public benefactor to the tradesman whom he robs; and that the same operation, repeated sufficiently often, would make the tradesman a fortune.

A final point from [The Consequences of 1.75% and 4.25%](#) is just as valid today as it was then. "The economists forecasting this recovery, said Alan Wood (*The Australian*, 22 January 2002), "are the same ones who failed to see the recession coming and failed to understand the nature and extent of the bubble that preceded it." Further,

Stock markets are still overvalued and the impact of the bursting bubble is still working its way through corporate America. The extraordinary case of the collapse of Enron raises the prospect that many more cases of bubble accountancy will be flushed out, with a corresponding effect on corporate and bank balance sheets, of the sort we saw in Australia in the late '80s and early '90s ... If this proves to be the case, the extent of stock market overvaluation will [be revealed] as the earnings side of projected earnings ratios deflates. Further falls in share prices will have an effect on household balance sheets and spending and U.S. recovery will prove both feeble and drawn out.

There is probably not much more that Greenspan can do about these risks via monetary policy, even if he cuts rates further. If there are grounds for labelling this the Greenspan recession, it is not because of his failure to cut interest rates far enough or fast enough. If he has made a mistake it is his failure to burst the asset price bubble earlier, [when he correctly recognised it in December 1996 as irrational exuberance](#). Instead he became the leading promoter of the new economy ..."

May 2008 to sell it. But it was unable to reach agreement with creditors on the terms of a sale, and in November 2008 Freightlink entered voluntary administration.

The Great Bubble and Regression to the Mean

Leithner & Co. could not and did not predict with any useful degree of accuracy what the mainstream has dubbed the “Global Financial Crisis” (i.e., the inevitable consequence of Western governments’ economically illiterate and criminally insane policies of interventionism). The insights of the [Austrian School of economics](#) did, however, enable it to diagnose the artificiality, fragility and impermanence of the boom, and to sidestep many of its damaging consequences (see also [Objectives and Possible Returns](#)). Like James Grant (quoted in the [Austrian Economics Newsletter](#)), so too Leithner & Co.:

What we do is look for extremes in markets: very undervalued or very over-valued. [The Austrian School of economics] has certainly given us an edge. When you have a theory to work from, you avoid the problem that comes with stumbling around in the dark over chairs and nightstands. At least you can begin to visualise in the dark, which is where we all work. The future is always unlit. But with a body of theory, you can anticipate where the structures might lie. It allows you to step out of the way every once in a while.¹⁷

Even before the Great Bubble began to inflate, Leithner & Co. was wary of the prices of most stocks and bonds. [The Consequences of 1.75% and 4.25%](#) quoted Alan Sloan (“Get Used to It: The Wall Street Party Is Over”, *The Washington Post* 4 June 2002): “sorry to be a party pooper, but the bull market that defined a generation and linked Main Street and Wall Street more intimately than ever is over, and it won’t be back for years and years – maybe not in our lifetimes ... The 30 percent S&P decline and the 70 percent Nasdaq decline from their peaks in March 2000 are a return to reality, not a passing hangover that will vanish tomorrow night when the party resumes.”

¹⁷ Grant’s insight generates others. Most notably, it’s mainstream economists who in actual fact are extremists – in the sense that they utter extremely absurd (even by their standards) things at the crest of a boom, and remain in resolute denial after boom has turned to bust. “My own view,” said Ric Battelino, the Deputy Governor of the RBA on 12 December 2007, “is that Australian households are in very good shape. They are not in any way exposed or vulnerable – the structure of assets and liabilities is quite sound. There would obviously be examples of people getting themselves into financial difficulty. But fundamentally, the household sector as a whole is in very good financial shape. We had an adjustment in the housing market over 2005 and 2006, but house prices are now rising again ... and there’s no hint the share market is grossly overvalued.”

Not to be outdone, the Governor of the RBA, Glenn Stevens, said on 18 January 2008 “Based on what we can see at present, my judgement is that the direct financial effects of the global turmoil on Australia are likely to be confined mainly to the impact on borrowing costs ... Taking into account the strength of demand, this increase in borrowing costs does not seem likely to pose a particular problem for the economy as a whole. There is no evidence, moreover, of a ‘credit crunch’ in the domestic financial sector.” Trying to be third-time lucky, on 14 August 2008 the irrepressible Battelino opined “Things have worked out, broadly speaking, the way we intended them to ... My feeling is that the worst is behind us. The write-offs the banks have been making have lessened in recent times. The big licks of losses are behind us now ...” Truly, arrogant morons govern Australia.

“This point,” the newsletter noted, “alludes to something that is presently discombobulating many market participants. In the words of Barrie Dunstan (*The Weekend Australian Financial Review*, 4-5 May 2002), ‘what is happening is probably a drawn-out phase during which over-priced stocks of all types are coming back to earth ... Forget about projections of economic growth in the United States or elsewhere. Stock markets at the moment aren’t about business prospects; they’re about the excessive valuations investors have been placing on shares. These valuations went far too high until early 2000. Now they are in the process of adjusting in what the experts call ‘reversion to the mean.’”¹⁸

Of Poindexter, Obama and Stimulus

What, then, of the next several years? Leithner & Co. has no crystal ball, but it does have the insights of the Austrian School. Unlike the mainstream, which is clueless about the causes of the distemper of our times and repeatedly confuses causes and symptoms, we have used these insights to diagnose the source of the difficulty (see in particular [Perhaps It’s Not Different This Time, After All](#) and [Once Again, Marxism Fails Miserably: Long Live Marxism?](#)). From this diagnosis it follows not only that governments’ increasingly crazed interventions have done and will do no good: they have and will continue to do much harm. In the 1930s, the state’s stupidity transformed a severe recession into the Great Depression. Today’s politicians, economists, etc., risk creating a vicious circle, whereby one failed intervention, which makes things worse, begets another, which worsens things further (see also [Interventionism Leads to War, War Generates More Interventionism](#)).

Economists who possess a detailed knowledge of history understand that the witchcraft and voodoo peddled by today’s mainstream reprises the errors of the 1930s. As theatre, propaganda and a vehicle for the evil Franklin Roosevelt’s political ambitions, the New Deal was a spectacular success; but as economics it was a dismal failure. In an address delivered in May 1939 – that is, after almost a decade of interventionism, first from Herbert Hoover, then from FDR – the U.S. Treasury Secretary, Henry Morgenthau, frankly confessed the catastrophe that the New Dealers had created. He thereby foretold the direction in which today’s anointed are leading the benighted:

¹⁸ A series of circulars to shareholders, entitled [Regression to the Mean and Value Investing](#), described the provenance and implications for investors of this fundamentally important notion. See also [Golden Era or Gilded Age? Inflation and Mean Regression in Australian Stock and Bond Markets, 1965-2006 – and Some Base Rates for 2007-2011](#) (a paper prepared for the National Investors’ Conference of the Australian Investors’ Association, 23-26 July 2006, Marriott Resort, Surfers Paradise, Queensland), [Speculators Extrapolate, Investors Think “Regression to the Mean”](#) and [Of High P/Es, Low Yields, Raging Inflation and Overstretched Asset Prices](#).

We have tried spending money. We are spending more than we have ever spent before and it does not work. And I have just one interest, and if I am wrong ... somebody else can have my job. I want to see this country prosperous. I want to see people get a job. I want to see people get enough to eat. We have never made good on our promises ... I say after eight years of this Administration we have just as much unemployment as when we started ... and an enormous debt to boot!

Almost seventy years later, *plus ça change, plus c'est la même chose*. Then, politicians and bureaucrats learnt that they couldn't flout the laws of economics. Today's lot will eventually learn the same lesson – at our expense. Memo to President O'Babble: no, you can't (see also [The Obama Stimulus Plan Won't Work](#) by Dom Armentano and [Obamanomics Will Fail the American People](#) by Michael Rozeff). Poor policies produced the Crash of 1929, and even worse ones turned it into the Great Depression. Statism has caused today's mess, and more intensive statism, in the form of Obama's "audacity of debt," is broadening and deepening it. Australia's Prime Minister has repeatedly vowed to do "whatever it takes" – except, of course, abandon the failed policies of the past. The lesson, then, is crystal clear: overthrow the institutional imperative! Unless he has compelling grounds to do so, no sane person should ever believe anything that any politician or mainstream economist or journalist ever says.

Principle 6: Buy With the Intention of Holding Indefinitely

A strategy of buy-and-hold (i.e., buying parts of good businesses with the intention of holding these investments as long as these businesses remain good, thus achieving returns commensurate with their under-lying economics) lies at the core of Leithner & Co.'s operations.

Few market participants can resist the temptation constantly to buy and sell securities. They feel the need to "churn" (i.e., to buy and sell within short periods of time) rather than wait for attractive opportunities to buy and then hold. During the first three months of 2001, for example, approximately 1,300 million shares of Telstra Corp. Ltd changed hands. On an annualised basis, that's 5,200 million (5.2 billion) shares changing hands. In 2001, Telstra had issued 12.866 billion shares and so Telstra's churn rate was $5.2 \div 12.866 = 40\%$. Taking into account the Commonwealth Parliament's ownership of 50% of these shares, annualised churn as a percentage of "free float" was ca. 80%. In other words, each tradeable share of Telstra was exchanged an average 0.8 times during 2001, and thus held for an average of 15 months.¹⁹

¹⁹ In 2001, the "churn rates" of the shares of major companies and within major institutional portfolios in the U.S. were often far higher. According to figures compiled by Timothy Vick, on an annualised (2000) basis each share of Compaq Computer changed hands 2.6 times. Corresponding turnover for Dell Computer was 2.9 times, America Online 4.9 times, and Yahoo! – brace yourself – 10.8 times.

In early 2009, not much had changed. In the three months to 15 February, the annualised churn rate of Telstra Corp. Ltd was 45% (not counting the large block of shares held by the Commonwealth's Future Fund). Table 1 shows churn rates for a short list of major Australian corporations.

Table 1: Implied Churn Rates for Major Australian Corporations, 15 February 2009

Corporation	Churn Rate	Average No. Months Held
Australia & New Zealand Banking Group Ltd	130%	9.25
BHP-Billiton Ltd	89%	13.5
Qantas Airways Ltd	179%	6.7
Telstra Corp. Ltd	45%	16.0
Westfield Group Ltd	146%	8.3

Churning is costly. On each side of the transaction brokers (or “croupiers” as Charles Munger, Berkshire Hathaway’s Vice-Chairman, has called them) extract a commission. Warren Buffett has estimated that the sum of all commissions, fees, etc., generated by churning is vast. [As he told *Fortune*](#) (22 November 1999), “my estimate is that investors in American stocks pay out well over \$100 billion a year – say, \$130 billion – to move around on those chairs or to buy advice as to whether they should! Perhaps \$100 billion of that relates to the FORTUNE 500. In other words, investors are dissipating almost a third of everything that the FORTUNE 500 is earning for them by handing it over to various types of chair-changing and chair-advisory ‘helpers’ ... In my view, that’s slim pickings.”

It is not sufficiently recognised, but is nonetheless fundamentally important to understand, that the more frequently one trades the poorer one’s results tend to become (see also *The Intelligent Australian Investor*, Chap. 2). This point applies as much to major institutions (whose portfolios’ annualised churn rates are often 50% and may exceed 100%) as it does to retail investors and day traders. The greater the frequency of trading the greater the amount paid in brokerage and commissions. And as Charles Ellis²⁰ has demonstrated, the more frequently one trades the more profitable one’s trades must be in order to counteract the “drag” imposed by commissions and other charges (see also Terrence Odean and Brad Barber, [Trading is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors](#)).

²⁰ See [The Loser’s Game](#) and *Winning the Loser’s Game: Timeless Strategies for Successful Investing* (McGraw-Hill, 2002).

In sharp contrast, Leithner & Co. attempts to locate and purchase a manageable number of securities whose values (at the time of purchase) exceed their prices. Once purchased, the intention is to retain these securities indefinitely. If their values do indeed exceed their prices, then over time such a portfolio will tend to generate reasonable returns for its owner.

To see this, consider as a thought experiment that we have \$100 to invest; that we invest it in a security whose value compounds at a rate of 15% per year and whose market price, by some miracle, always corresponds to our cautious estimate of its value. Assume for simplicity that capital gains tax (CGT) is levied at a rate of 15%; there are no brokerage fees, and the security's initial purchase price is \$1.00 per share. If we sold the security one year after we bought it then we would have an after-tax gain of \$0.105 per share and total investment capital of \$110.50. If we used this capital immediately to repurchase the security at \$1.15 per share, held these shares for a year, sold them, paid CGT, and repurchased every year, then after 10 years we would accumulate 70 shares, pay CGT of \$73, pocket \$271 and earn a compound rate of return of 10.1% per annum. If we paid brokerage fees of just 0.5% per transaction then after 10 years we would accumulate fewer (64) shares, pocket a lesser amount, \$245, and earn a lower compound return of 9.0% per annum. If, on the other hand, we purchase 100 shares at \$1.00 per share, hold them for 10 years (thereby delaying CGT and brokerage fees) and sell them at the end of the tenth year, then we would pay more (\$92) in taxes – but also pocket more cash (\$313) and increase the compound rate of return to 11.9% per annum.

Leithner & Co. has neither the talent nor the disposition to churn securities in anticipation of favourable short-term movements of their prices. Given the benefits of the buy-and-hold approach, it makes sense to devote considerable amounts of time and energy to the identification of securities with a significant “margin of safety.” And given the costs of churning, it makes sense to regard market prices not as signals to trade but rather as opportunities to acquire part-ownership of sound businesses at reasonable prices. Accordingly, with respect to the frequency of buying and selling (as opposed to the intensity of research) lethargy bordering upon sloth forms a cornerstone of its approach to investment.

Principle 7: Diversify, But Don't Over-Diversify

The securities of well-managed and cautiously-financed businesses are not often available at attractive prices. It thus makes sense to research diligently and wait patiently until such opportunities present themselves; and when they do, to place significant sums in those businesses.

Leithner & Co.'s investment portfolio tends to comprise a limited (10-20) number of securities. To diversify beyond this number is necessarily to lower

one's buying standards and to buy less discriminately; to do this, in turn, and as justified in detail in [Risk, Its Management and Disclosure](#), increases risk and reduces returns.

What's wrong with diversification? Up to a point, nothing. When a portfolio contains 10-20 securities, diversification is indeed very beneficial. Beyond this point, however, it greatly increases the chances that the buyer buys securities about which he knows (too) little. John Maynard Keynes outlined the rationale for focusing the portfolio in a limited number of investments. In a letter to a business associate dated 15 August 1934, he wrote:

As time goes on, I get more and more convinced that the right method in investments is to put fairly large sums into enterprises which one thinks one knows something about and in management of which one thoroughly believes. It is a mistake to think that one limits one's risk by spreading too much between enterprises about which one knows little and has no reason for special confidence ... one's knowledge and experience is definitely limited and there are seldom more than a handful of enterprises at any given time in which I personally feel myself entitled to put full confidence.

Philip Fisher lamented in *Common Stocks and Uncommon Profits* that far too few people consider the "evils" of extreme diversification. "This is the disadvantage of having eggs in so many baskets that a lot of the eggs do not end up in really attractive baskets, and it is impossible to keep watching all the baskets after the eggs get put into them." Diversification has been "so oversold" that the fear of having too many eggs in one basket has caused people to put far too few eggs into companies they thoroughly understand and far too many in others about which they know next to nothing. "It never seems to occur to them, much less their advisors, that buying a company without having sufficient knowledge of it may be even more dangerous than having inadequate diversification."

Similarly, Warren Buffett says "diversification serves as a protection against ignorance. [It] makes very little sense for those who know what they're doing." Further, "if you want to make sure that nothing bad happens to you relative to the market, you should own everything. There's nothing wrong with that. It's a perfectly sound approach for somebody who doesn't know how to analyse businesses." If, however, "you are a know-something investor, able to understand business economics and to find ... sensibly priced companies that possess important long-term competitive advantages, [then] conventional diversification makes no sense for you."²¹ In short, if it raises both the intensity with which an investor thinks about a business and the comfort he must derive from its operations before becoming an owner or part-owner, then a strategy

²¹ See Janet Lowe, *Warren Buffett Speaks: Wit and Wisdom from the World's Greatest Investor* (John Wiley & Sons, 1997), Robert Hagstrom, *The Warren Buffett Portfolio* (John Wiley & Sons, 1999) and particularly Frank Shostak, [Diversification: An Austrian View](#).

of mental and financial concentration may *lessen* the risk that accompanies any investment operation.

Principle 8: Remember That Risk Accompanies Any Investment

Mammoth and esoteric tomes have been written, and much popular ink has been spilt, about the concept of risk. Yet despite academics' strenuous (and largely successful) attempts to complicate it unnecessarily, the concept is very simple: it is the probability that a bad thing might happen. Applied to investments, "risk" has nothing whatever to do with the volatility of the price of a security. Rather, it has everything to do with the likelihood that (i) one pays more for a security than a reasoned assessment of its worth justifies; and (ii) that a sound company ceases at some point in the future to exhibit this characteristic.

Most market participants, including institutions, brokers, advisors and private investors, define investment risk in terms of the short-term ups-and-downs of a security's market price (relative either to comparable securities or that of 'the market' as a whole). As a result, the practice of investment risk management is conventionally understood as an attempt to reduce within acceptable bounds the short-term variability – particularly in a downward direction – of an investment portfolio's current market worth.

Graham-style value investors disregard both the conventional definition of risk and the standard practice of risk management ([Risk, Its Management and Disclosure](#)). Their impertinence, and in some cases scorn, extends to the body of academic literature which underlies this definition and practice. In Mr Buffett's words, "for owners of a business – and that's the way we think of shareholders – the academics' definition of risk is way off the mark, so much so that it produces absurdities." Among the many examples: Berkshire Hathaway, Inc., which Mr Buffett chairs, bought a substantial stake in The Washington Post Company in 1974. The price paid implied that TWPC, considered as a whole, would fetch \$80m. Yet "if you'd asked any one of 100 analysts how much the [entire] company was worth when we were buying [a portion of] it, no one would have argued with the fact that it was worth \$400m."

The downward-volatility of the price of TWPC's shares enabled Buffett, at a propitious moment, to buy a significant percentage of the company at a fraction of a cautious assessment of its value. In effect, he was buying assets worth \$1.00 for only \$0.20. According to academic conceptions of risk and the standard practice of investment risk management, however, the volatility of TWPC's shares made their purchase a risky proposition. Indeed, the greater the shares' price volatility and the lower their purchase price, the *riskier* is the investment. As Buffett concluded incredulously, "with that, [the academics] have lost me." Risk derives from the correspondence of one's premises and

logic to reality – not from the ups and downs of the price of a security. The market capitalisation of Berkshire's stake in The Washington Post Company, for which it paid \$10.6m in 1974, has subsequently fluctuated wildly – to \$150m in 1984, \$419m in 1994 and \$1.4 billion in 2004.

Absent any change in a company's operations or prospects, then, any sudden or unanticipated fluctuation of the market price of its shares does not make an investment in the company "risky." Once he has acquired part-ownership of a company at a sensible price, the investor monitors its operations and prospects; and as long as these remain constant or improve he retains confidence in his judgement. If the price of its shares decreases after purchase – again, assuming no change in the business's operations or prospects – he will not be alarmed. On the contrary, in the absence of more favourable opportunities he will consider the purchase of more shares.

As Graham put it in *The Intelligent Investor*, "the bona fide investor does not lose money merely because the market price of his holdings declines, and the fact that a decline may occur does not mean that he is running a true risk of loss ... we apply the concept of risk solely to a loss which is either realised through actual sale, or is caused by a significant deterioration in the company's position-or, more frequently perhaps, is the result of the payment of an excessive price in relation to the worth of the security."

Principle 9: Adopt a Sensible Criterion of Success

Graham-style value investing, it has been emphasised, builds upon the foundation that investment is most successful when it is most businesslike. Similarly, the measurement of the results of one's investment operations is most sensible when it too is businesslike. One's results, in other words, have everything to do with the earnings which one's businesses generate and nothing to do with the extent to which the prices of their shares fluctuate. As a business, Leithner & Co. thus gauges its own results in the same way that it would gauge the progress of any other business, e.g., by its earnings, margins and return on equity.

Academic conceptions of risk, the standard practice of investment risk management and the institutional imperative conspire to bastardise the criteria by which most market participants measure their results. The vast majority obsess about "the market" and its short-term (i.e., yearly, semi-annual or even quarterly) "performance." They define the market in terms of a price index such as the All Ordinaries Index; they think about their own portfolios as an index; and compare the "performance" of that portfolio with that of the All Ord or some other index. Accordingly, the greater is an index's increase from one point in time to another, the more favourable is the evaluation of its performance. Conversely, the smaller is the rise (or the greater the decrease) the more negative is the interpretation. Further, if Index A (say, Jack's port-

folio) increases relative to Index B (Jill's portfolio or some market index), then A has "outperformed" B.

Most market participants' obsession about overall markets leaves them little time to analyse individual businesses and securities. Let us assume that the economic bases, operations and prospects of a business change little from one day to the next; indeed, one might contend that the prospects of an established business with a history of sound results do not change significantly from one year to the next. If so, then the day-to-day ups-and-downs of its stock (if it is quoted on an exchange) tell us nothing about these fundamentals, operations and prospects. Clearly, some price changes stem directly from the appearance of genuinely new information. Equally clearly, however, the importance of new information is not often immediately apparent; and in any case most price fluctuations bear little or no direct relation to genuinely new information about operations and prospects. Accordingly, it is superficial influences, as opposed to fundamental changes to the business, which are reflected in day-to-day, week-to-week and month-to-month fluctuations of a stock's price. Hence the absurdity of defining the "performance" of a stock or a bundle of financial assets in terms of short-term price changes becomes apparent.

In *The Warren Buffett Portfolio*, Robert Hagstrom asks "if you owned a business and there was no daily quote to measure its performance, how would you determine your progress? Likely you would measure the growth in earnings, or perhaps the improvement in operating margins, or a reduction in capital expenditures. You would simply let the economics of the business dictate whether you are increasing or decreasing the value of your business." In order to buy or sell a security, one requires a price. In order to evaluate its worth, one does not: rather, one requires valid and reliable information about the business, its operations and prospects (see also [Value Investing and the \(Mis\)Measurement of Results](#)).

Principle 10: Explain Yourself Plainly and Remember the People Involved

Graham asked his students "have you ever seen a human being mentioned in a corporate business plan?" and beseeched them to "always remember that you are dealing with people and their hard-earned savings."

Are financial markets falling, or is the sky? In the December quarter of 2008, the answer to this question, like much else, was uncertain. Beginning in September, comparisons between current conditions and the early phases of the Great Depression filled the newspapers and airwaves; and in the year to 31 December, the All Ordinaries returned its worst-ever result (-45.7%). This loss greatly exceeded those incurred during the Crash of 1987 and the recessions of the early 1990s, 1980s and 1970s, as well as the Great Depression. In the U.S.,

financial markets as a whole plunged more in 2008 than at any time since the “Depression-Within-the-Depression” of 1937-38.

To a Grahamite with plenty of cash, a bracing bear market is a potential opportunity. Younger disciples can appreciate most directly the appeal of dramatically lower prices. Hence they should rejoice when stocks and bonds go on sale – for they will enjoy the benefits in the years to come. For older disciples, the point is psychologically much more difficult to accept; cognitively, however, it is no less compelling. Yes, their retirement nest eggs have shrunk significantly. But part-and-parcel of older investors’ wisdom is a greater propensity to hold cash and other liquid assets. These will sustain them through the bust. Surplus liquid assets will also buy considerably more stocks and bonds today than they did during the boom. Hence the family members (namely children and grandchildren) of older investors will enjoy the benefits.

But we mustn’t forget – Graham never did – that we’re talking about human beings and human nature. Not even the purest seeker of investment value is likely to welcome a bear market with nothing but calm in his breast and cash in his trousers. Ordinarily, falling prices improve valuations. But they also mean mark-to-market losses for securities purchased at bullish prices. Objectively, that strains the plans of some investors. And subjectively, rare is the investor who is immune to the nausea that tosses market participants during a storm. Just when the bargains are most compelling, the human heart is likely to develop an ardent fondness for cash under the mattress.

Hence the relevance for us of Graham’s experiences during the 1930s. At the nadir of the Great Depression, he was 38 years of age – but his mother, whose finances he managed, was almost 70. To gauge Graham’s state of mind, it’s important to recall that his brains have been long and justly celebrated. Graham was a true polymath. Upon graduating from Columbia University in 1914, he was offered a teaching position in three departments (Classics, English and Mathematics). That had never occurred before, and it has never happened since. Yet Graham ploughed even broader intellectual paddocks. He wrote a play (it debuted on Broadway but closed after two nights) and poetry (none of it published), and also invented “more practical” furniture and an allegedly “better” slide rule (none of which the bureaucrats in the U.S. Patent Office agreed to patent). Alas, and by his own admission, Graham’s passions exceeded his morality and propriety. *Fortune* Magazine, in a tribute it published on the occasion of his induction into the U.S. Business Hall of Fame, said that the thrice-married father of value investing “leaped from blonde to blonde like an Alpine goat springing from peak to peak.” Clearly, Graham was a complex mixture of reason and emotion, and the Depression sorely tested both his head and his heart.

On the eve of the Crash of 1929, Graham was managing what we would today regard as a hedge fund. He was “long” \$2.5 million of stocks and bonds, and “short” the same amount. Considered as a whole, those positions were not unduly exposed to any change of the prices of the underlying securities. In addition, however, he owned \$4.5 million in outright long positions, and had incurred substantial margin debt in order to own them. In his posthumously-published memoir, entitled *Benjamin Graham: The Memoirs of the Dean of Wall Street* (McGraw-Hill, 1996), the father of value investing described his state of mind in these terms: “We were convinced that all of our long positions were intrinsically worth their market price.” But by heavily mortgaging himself, Graham unwittingly transformed a conservative stance into a risky one. From the top to the bottom – that is, from 1929 to 1932 – his fund’s valuation fell by 70%. That was a better showing than the 87% drop of the DJIA (today’s funds managers might exult at his “outperformance”), but Graham never pretended that it was anything other than a calamity.

In the wake of the Crash and at the nadir of the Depression, the once and future investment genius sorely needed income. Where could he find it? At *Forbes*. Graham was a good writer, and in the early 1920s he had slummed in financial journalism. In his memoir he describes the “feeling of defeat and near-despair that almost overmastered me towards the end” – the end, that is, of the washout. But he didn’t succumb to his personal great depression. Near the rock bottom of the decline, he collected himself and his thoughts, and restated the straightforward case for common stocks.

“Is American Business Worth More Dead Than Alive?” was the theme that ran through his three-part series of late June and early July 1932.²² He reminded his readers that one-third of America’s listed industrial stocks were priced at less than the pro rata share of their companies’ net current assets. In other words, their non-current net assets (i.e., property, plant and equipment, as well as intangibles such as goodwill, copyrights, trademarks and patents) was given a value of \$0.00 on the floor of the stock exchange.

Graham treated this fact not only with wonder, but also with well-reasoned indignation. In the long-vanished boom, companies had raised billions of dollars from the public. Now they were stuffed with cash, but John Q. Citizen was struggling to pay the rent and put food on the table. The only rational way to explain the existence of so many cheap stocks, Graham proposed, was that buyers and sellers in the market, in their wisdom, had concluded that operating losses would continue for years and perhaps even decades. But if so, he asked, “should not the stock-holder demand liquidation before his money is thus dissipated?”

²² See [Should Rich Corporations Return Stockholders’ Cash?](#) and [Inflated Treasuries and Deflated Stockholders](#) and [Should Rich but Losing Corporations Be Liquidated?](#)

In Graham's view, market participants simply weren't being sensible. How could it be otherwise when the people who sold refused even to look at balance sheets? "Much of the past year's selling of stocks has been due to fear rather than necessity," he wrote. "If these timid holders were thoroughly aware that they were selling out for only a fraction of the liquid assets behind their share, many of them might have acted differently. But since valuation has come to be associated exclusively with earning power, the stockholder no longer pays any attention to what his company owns – not even its money in the bank." If "earning power" was the cry of the boom, "losing power" was the leitmotiv of the bust.

"Is it true," Graham asked, "that one out of three American businesses is destined to continue losing money until the stockholders have no equity remaining? That is what the stock market says in no uncertain terms." He answered his own question: "In all probability [the market] is wrong, as it has always been wrong in its major judgments of the future. The logic of Wall Street is proverbially weak. It is hardly consistent, for example, to despair of the railroads because the trucks are going to take most of their business, and at the same time to be so despondent over the truck industry as to give away shares in its largest units for a small fraction of their liquid capital alone."

The series in *Forbes* bracketed the Dow's 8 July absolute bottom. Graham had never made market calls or taken others' seriously; but on that occasion, and virtually alone, he was bullish when one ought to have been bullish – and in 1933, his portfolio's valuation increased by 50%. That wasn't enough to recoup his losses – that would have to wait until 1936 – but it was a start. Of course, at the bottom of the market, being bearish comes naturally, and psychological depression was highly contagious in the final summer of the administration of Herbert Hoover.

Competing for the attention of the reading public at about the time that Graham's series of articles was running in *Forbes* was a new book from Harper Brothers entitled *Is Capitalism Doomed?* Yes indeed, the author, Lawrence Dennis, concluded. Fascism, he prophesied, either Mussolini's or the New Dealers' variant, was the way of the future. It would "supplant the now disintegrating laissez-faire liberal capitalism of the past century."²³ The book

²³ Dennis published a second book, *The Coming American Fascism*, in 1936. Several of its passages provide an uncanny description of events during 2008. In a chapter entitled "Why Fascism Instead of Communism?" Dennis declared "Private ownership of savings ... can be socially controlled. The social abuses connected with savings are encountered mainly in the mechanics of investment and financial management by the large banks, savings institutions, and insurance companies which handle savings. It is a relatively easy matter for the State to preserve the present *de facto* rights and interests of small savers while completely nationalizing the financial institutions which now administer their savings." Dennis continued: "It cannot be repeated too often that what prevents adequate public regulation is liberal norms of law and constitutional guarantees of private rights. There is

critic of *The New York Times* – then and now, *The Times* applauds any and all proposals to unchain the state and straightjacket the individual – reviewed Dennis’ book very favourably.

Consistency, apparently, is the hobgoblin of small (or at least classical liberal) minds. Two years later, the same critic, Louis Rich, assessed Graham’s book (co-authored with David Dodd of the Columbia Business School) *Security Analysis*. He liked it too. “On the assumption that despite the debacle of recent history there are still people whose money burns a hole in their pockets, it is to be hoped that they will read this book. It is a full-bodied, mature, meticulous and wholly meritorious outgrowth of scholarly probing and practical sagacity.” After three-quarters of a century, Rich’s verdict still stands.

Graham was an educated man who happened to invest: he was not an investor who, in order to land a job or advance his career, decided to attend university. Throughout his entire life, he read, thought and wrote. As an educated man, he was able to assume a certain detachment from the times through which he lived. His head told him that the Great Depression was a “six-sigma” event – that is, a catastrophe that would not recur during his lifetime and therefore against which an investor need not arm himself. It was, in short, a tragic fluke.

Yet Graham was just as fallible as any human being, and so sometimes he lost his sense of perspective. A prime example occurs at the end of the 1940 edition of *Security Analysis*. In Graham’s mind loomed not only the Crash of 1929 and the Great Contraction of 1929-1933, but also the Depression-Within-the-Depression and the accompanying brutal bear market of 1937-38. During the preceding decade Graham had been through the mill, and his advice to the managers of trust funds, endowments and other such institutions contained as much emotion as reason. How should they invest? Graham proposed that they should buy bonds – then yielding all of 2-3% – and give common stocks a wide berth. *Say what?* Avoid the very asset class he had dissected so painstakingly over most of the preceding 725 pages? Amazingly, that was his considered advice. “We doubt,” Graham somewhat cryptically concluded, “if the better performance of common-stock indexes over past periods will, in itself, warrant the heavy responsibilities and the recurring uncertainties that are inseparable from a common-stock investment program.”

History records that, from a financial point of view, the Great Depression disappeared from the front pages of American newspapers and entered that country’s history books in May-June of 1942. (From an economic point of

no need to expropriate private ownership of ... savings ... in order to maintain adequate social control ... The fascist State can easily convert the ... large corporations into State-controlled enterprises, the present owners and creditors of which will receive income bonds ... There is no real difference between being a yes-man official of a billion dollar bank and being an official of a State bureaucracy ...”

view, its end had to wait until 1946-47). On 4-8 May, in the Coral Sea off the coast of Queensland, Allied forces effectively halted the Japanese advance in the Pacific; and on 4-7 June, around an obscure island called Midway, the U.S. Navy turned the tide. On financial markets, May-June witnessed a buyers' panic which, over the next several months and years, became a bull market. Between May of 1942 and June of 1946, the DJIA rose from 101 to 206. Yet not until 1954 would it overtake the high it reached in 1929. Perhaps for this reason, in the minds of many – including Graham – the Great Depression continued to live long after it died.

Hence the paradox: the concluding chapter of the 1940 edition of the best and most influential book ever written about investing contains some of the worst advice about long-term investment that has ever been offered. Even people like Graham are not exempt from a perverse rule. Indeed, they are particularly subject to this rule: market participants are likely to develop an ardent devotion to cash under the mattress just when (in retrospect the point of maximum pessimism is always obvious) the bargains are most compelling.

It's therefore important to repeat: Graham was a complex mixture of reason and emotion. Events in financial markets since the middle of 2007 remind us that between 1929 and 1932 his investment partnership lost 70%; not until 1936 did it recoup all it had relinquished; and in 1937-38 it suffered fresh losses. Yet for more than a decade he persevered and, with his partner, Jerry Newman, proceeded to achieve an excellent long-term record – not excluding those disastrous years. We have all heard the platitude “The first rule of investing is not to lose money and the second rule is not to forget the first.” Sometimes – and particularly on the downward leg of what might be a severe and extended bear market – that advice simply isn't helpful. What *is* useful is knowledge of Graham's mindset and journey as well as his philosophy. They demonstrate that a severe loss is no reason to capitulate.

To buy assets whose value exceeds their price, and to ignore (or at least endure stoically) short-term fluctuations and vicissitudes, is the essence of investing. In Graham's words, “basically price fluctuations have only one significant meaning for the true investor. They provide him with an opportunity to buy when prices fall sharply and to sell wisely when they advance a great deal. At other times he will do better if he forgets about the stock market and pays attention to his dividend returns and to the operating results of his companies.” And at all times, fashion and conventional wisdom are no substitutes for clear premises, hard evidence and valid reasoning. In this manner “through chances various, through all vicissitudes, we make our way” (Virgil, *The Aeneid*).

Chris Leithner
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